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In the Supreme Court of the United States

OCTOBER TERM, 1986

LILLIAN K. SHENKER, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

MEMORANDUM FOR THE RESPONDENT IN OPPOSITION

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Petitioner contends that the court of appeals erred in rejecting her claim for "innocent spouse" relief under Section 6013(e)(2) of the Internal Revenue Code.

1. Petitioner filed joint tax returns for 1966-1969, the tax years in issue, with her husband, Morris A. Shenker. On those tax returns, loss deductions were claimed based on Morris Shenker's investment in various real estate ventures owned and controlled by Irving J. Kahn. One such project was a building located in San Diego, California, known as the Electronics Capital Building (ECB). Pet. App. A2, A29.

ECB had been completed in May 1963 by its original owner, First & C Corporation (F&C), a corporation owned by Kahn and three other persons. Because of losses incurred in operating the building, F&C soon found itself in serious financial straits. To resolve these financial difficulties and to attract new investors, Kahn arranged in March 1966 for

the transfer of F&C's interest in ECB to Penasquitos Corporation (Penasquitos), a real estate development corporation that he controlled, which had assets exceeding $10 million. For its part, Penasquitos assumed all of F&C's outstanding indebtedness and executed a note to F&C.

At some point in early 1966, Kahn approached Morris Shenker about investing in ECB. An agreement was signed under which Penasquitos pledged to act as agent for Kahn and Morris Shenker, as undisclosed principals, in the acquisition and operation of ECB. Morris Shenker then arranged, and personally guaranteed, a $250,000 bank loan to Penasquitos. Shenker in other respects took no part in any decisions concerning ECB's operations, which were managed exclusively by Penasquitos. Pet. App. A28-A29.

In a series of transactions around April 1967, new investors acquired a collective 50% interest in ECB from Kahn for $200,000. Penasquitos thereupon conveyed legal title to ECB to the Title Insurance and Trust Company of San Diego (Title Company), which agreed to act thenceforth as agent for Shenker and the new investors in holding title to ECB, although Penasquitos continued to play some role in the operation of the building. In June 1967, Shenker arranged and personally guaranteed a $60,000 bank loan on behalf of ECB, which was treated on ECB's books as a loan from Shenker. In November 1967, Shenker arranged a $100,000 loan to Title Company, which was secured by a deed of trust signed by Shenker and others. Pet. App. A29-A30.

For the years 1966-1969, ECB filed partnership returns reporting losses ranging from approximately $115,000 to $362,000. Morris Shenker claimed a 50% distributive share of those losses on the joint returns that he filed with petitioner for those years (Pet. App. A30). The Commissioner disallowed the deductions on the ground that they were attributable to Penasquitos or to Title Company, rather

than to Shenker. Petitioner and Morris Shenker thereafter instituted this proceeding for redetermination of the resulting deficiencies in the Tax Court, arguing that Shenker had a 50% ownership interest in ECB, and that Penasquitos and Title Company were acting as his agents in holding title to and managing ECB.

2. The Tax Court sustained the Commissioner's determination (Pet. App. A1-A26). Examining the indicia of agency set forth in *National Carbide Corp.* v. *Commissioner*, 336 U.S. 422, 437 (1949), the court found that neither Penasquitos nor Title Company had acted as Shenker's agent in acquiring or operating ECB (Pet. App. A14-A21). The court found that the existence of a written agency agreement was not enough to override the evidence that (1) Penasquitos was acting on its own behalf in acquiring and operating ECB (*id.* at A16); (2) Shenker was not bound by Penasquitos' actions (*id.* at A16-A17); (3) Penasquitos did not transmit its receipts to the partners (*id.* at A17); (4) the income from the project was attributable to Penasquitos' efforts, not Shenker's (*ibid.*); and (5) the extent of Penasquitos' involvement in the management of ECB went beyond the normal duties of an agent (*id.* at A18).[1] The court further found that Shenker did not acquire an ownership interest in ECB as a result of its conveyance by Penasquitos to Title Company in April 1967, although he did make efforts to secure financing for the project and personally guaranteed $410,000 of its obligations (*id.* at A19-A21).

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[1]The court did find (Pet. App. A17-A18) that "the purported agent's relationship with [Shenker] and Kahn, the purported principals, was not based upon common ownership and control," and it therefore concluded that the "fifth *National Carbide* factor" was satisfied. Accordingly, the issue presented in the pending petitions for certiorari in *Frink* v. *Commissioner*, No. 86-1151 (filed Jan. 13, 1987), *George* v. *Commissioner*, No. 86-1152 (filed Jan. 13, 1987), and *Commissioner* v. *Bollinger*, No. 86-1672 (filed Apr. 16, 1987), has no bearing on this case.

3. While this case was pending before the Tax Court, Congress retroactively amended the "innocent spouse" provision of Section 6013(e) of the Internal Revenue Code.[2] That provision permits a spouse who files a joint return to escape liability for an understatement of tax on the return under certain circumstances. Under the amended version, one relevant factor is whether the understatement is "attributable to grossly erroneous items of one spouse" (I.R.C. § 6013(e)(1)(B)). "Grossly erroneous items" are defined to include "any claim of a deduction * * * in an amount for which there is no basis in fact or law" (I.R.C. § 6013(e)(2)(B)).[3]

Petitioner sought to qualify for "innocent spouse" relief under amended Section 6013(e) from any tax liability stemming from disallowance of the ECB loss deductions. Thus, whereas she had contended in the original Tax Court petition filed jointly with her husband that his deductions of the ECB losses were correct, she filed a motion with the Tax Court in April 1985 contending that those deductions not only were incorrect, but also were "grossly erroneous." She requested a supplemental hearing in order to present evidence concerning her asserted lack of knowledge of the understatement of tax attributable to the deductions in issue (Pet. App. A25).

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[2]Unless otherwise noted, all statutory references are to the Internal Revenue Code (26 U.S.C.), as amended (the Code or I.R.C.).

[3]Section 424 of the Deficit Reduction Act of 1984, Pub. L. No. 98-369, 98 Stat. 801, renders the amendment effective retroactively (for the benefit of taxpayers) for all taxable years to which the Internal Revenue Code of 1954 applies in any case pending before the courts on July 18, 1984. Under prior law, relief under Section 6013(e) had been limited to instances in which understatements of tax were caused by omissions from gross income. See, *e.g.*, *Resnick* v. *Commissioner*, 63 T.C. 524, 527 (1975). The spouse seeking relief under the amended statute must also establish that in signing the return he or she did not know or have reason to know that there was a substantial understatement of tax and that it would be inequitable to hold him or her liable for the deficiency. I.R.C. § 6013(e)(1).

The Tax Court denied petitioner's supplemental motion (Pet. App. A24-A26). The court found that the claimed loss deductions "were not phony business deductions for which there was 'no basis in fact or law' " (*id.* at A26) and hence were not "grossly erroneous items" within the meaning of Section 6013(e)(2). The court noted in this connection that the deducted expenses were in fact incurred and deductible; the dispute concerned whether Morris Shenker was entitled to deduct them (Pet. App. A26). Because the Tax Court's finding that the understatement was not attributable to "grossly erroneous items" precluded relief as a matter of law, the court found it unnecessary to hold a hearing on whether petitioner otherwise satisfied the statutory requirements for "innocent spouse" relief.

The court of appeals unanimously affirmed (Pet. App. A27-A38). The court upheld the Tax Court's conclusion that Morris Shenker was not entitled to the deductions in issue, but agreed that his claim to those deductions was not so utterly baseless that they constituted "grossly erroneous items" within the meaning of Section 6013(e)(2) (Pet. App. A31). The court explained that, although Shenker did not prevail on his claim that Penasquitos and Title Company were his "agents," his contention "was not entirely groundless" because he actually entered into agency agreements with those entities and also personally guaranteed the loans he obtained for ECB (*id.* at A35).[4]

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[4]This case was consolidated on appeal with another appeal by petitioner seeking "innocent spouse" relief, which was taken from a separate decision of the Tax Court involving different items and other taxable years. In that case, the court of appeals reversed the Tax Court's determination that a disallowed stock loss deduction did not constitute a "grossly erroneous item," and it remanded the case for a determination whether the remaining requirements of Section 6013(e) were met (Pet. App. A35-A38).

4. Petitioner challenges the court of appeals' holding that the deductions in issue were not "grossly erroneous items" within the meaning of Section 6013. This challenge is without merit. The decision below is correct, and petitioner does not allege (nor is there) a conflict with any decision of this Court or of any other court of appeals. Petitioner has raised no issue warranting review by this Court.

The only legal basis given by petitioner for her contention is the assertion (Pet. 15) that the decisions below are internally inconsistent in denying her innocent spouse claim while at the same time denying her husband's entitlement to deduct the expenses in question. In short, petitioner argues that any deduction that is not allowed is ipso facto without any "basis in fact or law" (I.R.C. § 6013(e)(2)(B)). This interpretation is manifestly wrong; it would effectively eliminate the "grossly erroneous" limitation from the statute.

Congress's intent, embodied in the plain language of the statute and its legislative history, was to limit "innocent spouse" relief to "grossly erroneous items" (to which it might reasonably be presumed a knowing spouse would have objected). The Tax Court has recently interpreted the term "grossly erroneous items" as meaning claims that are "fraudulent," "frivolous," "phony," or "groundless." *Douglas* v. *Commissioner*, 86 T.C. 758, 763 (1986); *Purcell* v. *Commissioner*, 86 T.C. 228, 240 (1986), appeal pending, No. 86-1678 (6th Cir.); *Sivils* v. *Commissioner*, 86 T.C. 79, 83 (1986). This common-sense reading of the statute is supported by the House Report, where Congress noted that it intended to extend "innocent spouse" relief to situations where, for example, "one spouse claims phony business deductions in order to avoid paying tax and the other spouse has no reason to know that the deductions are phony" (H.R. Rep. 98-432, 98th Cong., 2d Sess. Pt. 2, at 1502 (1984)).

Under the amended statute, a deduction would be held to have "no basis in fact" if, *e.g.*, the outlay for which it was claimed had not actually been made. Similarly, a claim for a deduction would have "no basis in law" if no substantial legal argument could be made in support of the deduction, even if the expense were actually incurred. See *Douglas* v. *Commissioner*, 86 T.C. at 762-763. Thus, eligibility for "innocent spouse" treatment with respect to a deduction requires a finding that the claim for a deduction lacks any color of validity. So long as there is some basis in fact or law for the claimed deduction, the item is not "grossly erroneous" within the meaning of Section 6013(e)(2), even if the deduction is ultimately disallowed. Petitioner gives no reason why this interpretation of the statute's plain terms should be rejected, nor does she cite any case that has adopted a contrary interpretation.

Under this standard, there can be little doubt that the court of appeals correctly sustained the Tax Court's conclusion that the deductions in question, while incorrect, were not "grossly erroneous." Indeed, apart from her blanket assertion that any disallowed deduction is "grossly erroneous," petitioner does not seriously take issue with this conclusion. As the Tax Court found (Pet. App. A26), the ECB loss deductions were based on expenses actually incurred and deductible under various provisions of the Internal Revenue Code. The primary legal issue presented was whether Morris Shenker had a sufficient ownership interest in the properties, either directly or through an agent, to sustain his claim to a portion of those deductions. That issue was not entirely free from doubt. Indeed, Shenker successfully argued that he did have a sufficient ownership interest to deduct the expenses incurred in two other real estate ventures, Loma Palisades and Pennant Village (*id.* at A21-A24). Although Shenker did not prevail with respect to the deductions relating to ECB, the courts below correctly found that his attempt to do so had some legal basis.

As the court of appeals explained (*id.* at A35), Shenker's assertion of ownership in ECB was not wholly without foundation because there were facts supporting that claim—viz., he actually entered into agency agreements with both Penasquitos and Title Company and personally guaranteed the loans he obtained on their behalf.

It is therefore respectfully submitted that the petition for a writ of certiorari should be denied.

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